

These national trends are playing out in the Mid-Atlantic region, with rising healthcare costs, significant investment requirements, increased scale of competitors, for-profit conversion and small plans closing down or being acquired.

Each of these trends is affecting CareFirst specifically. For example, over the past three years, CareFirst experienced average annual healthcare cost increases of 7.8% in its Commercial HMO business, and 10.0% in its Maryland Small Group business.

Like other health plans, CareFirst is investing to improve service to customers and to comply with changing regulatory requirements. Because of limited access to capital, CareFirst has had to sequence new efforts, deferring, for example, some critical eCommerce initiatives (particularly provider and member self service initiatives).

The Mid-Atlantic region has seen consolidation as well: Coventry Health Care purchased all or parts of 11 health plans in a three-year period; Aetna acquired U.S. Healthcare, NYLCare, and Prudential Healthcare. Several smaller plans have gone out of business or been acquired, including the George Washington University Health Plan, Innovation Health, and the QualChoice of Virginia Health Plan. Blue Cross and Blue Shield of Virginia, now known as Trigon, converted to for-profit status and became a publicly traded company in 1997. CareFirst itself represents the affiliation of Blue Cross Blue Shield plans serving Maryland, the Washington D.C. region, and Delaware.

We believe that to maintain its competitiveness in the face of these industry pressures, CareFirst would benefit from a substantial increase in scale and capital access. One of the options available to CareFirst to do so quickly would be to combine with a large, for-profit health plan.

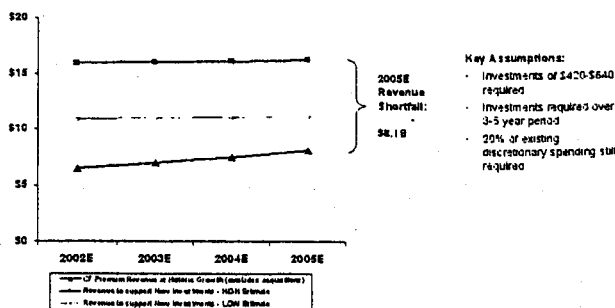
Accenture helped CareFirst estimate that a scale of \$11-\$16 billion in annual revenue could greatly aid it in maintaining competitiveness over the next several years. This range was estimated based on our assessment of CareFirst's capital needs, which includes:

- Making the strategic investments described earlier in this document, estimated to be \$90 - \$190 million over three to five years, and
- Funds for opportunistic acquisitions of smaller plans in the Mid-Atlantic region. Our examination of other transactions led us to estimate that a plan the size of CareFirst could spend as much as \$330-450 million in such transactions.

We used two methods to estimate a potential target revenue range for CareFirst. First, we analyzed CareFirst's recent income statements to assess how much income CareFirst has been able to devote to strategic/acquisition investments. We compared CareFirst's historical investment budgets with our estimate of investment needs in order to estimate the desired scale. Second, we examined the size and growth rates of CareFirst's competitors in the Mid-Atlantic region, and projected the size CareFirst would have to be in order to not lose ground (in terms of scale) relative to those competitors. The result of these two methods was an estimate of desired size for CareFirst of \$11-\$16 billion in annual revenue.

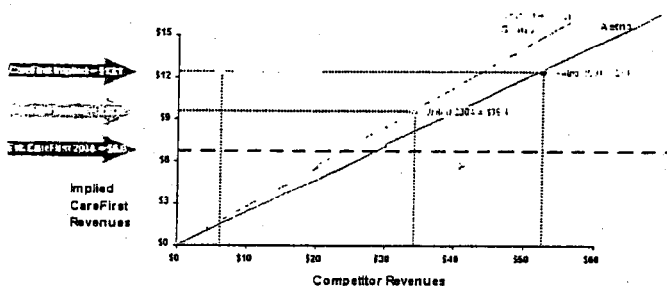
CareFirst's Projected Revenue to Support Investments

CareFirst Revenue Required to Support Investments
(\$ in Billions, 2002E - 2005E)



CareFirst's "Implied" Revenue Compared with Competitors

CareFirst "Implied" Revenue to Maintain Size Relative to Competitors, 2004
(\$ in Billions)



Source: CareFirst data, SEC Reg. 17, 1995-1998

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CareFirst Advantageous Size Target

Estimated Advantageous Target Size Range for CareFirst in 3-5 Years
(measured in billions of revenue dollars)

Estimation Method	Low	High
Investment Support Level	\$11.2	\$18.2
Scale Relative to Competitors	\$10.9	\$13.1
Estimated Revenue Target (in billions)	\$11	\$18

Source: CareFirst data, SEC Reg. 17, 1995-1998

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This revenue scale would be very difficult for CareFirst to achieve through home-market expansion (i.e., through incremental growth). Just being able to support the strategic investments would require substantial market share expansion, adding as many as 1.4–3.1 million members to its 2000 year-end membership. Another option would be to expand beyond CareFirst's present boundaries; however, CareFirst's Blue Cross Blue Shield brand license limits CareFirst to competing with the Blue Cross Blue Shield brand in its current geographic markets. And, while less formal affiliations can provide some business and marketing benefits, they

generally limit the opportunities to achieve economies of scale compared with true mergers.

Although the affiliations CareFirst already has in place enable it to maintain a larger capital base, state-mandated CareFirst-specific regulations restrict the ease with which this capital can be deployed. Financial transactions and asset allocations greater than \$500,000 require affiliated CareFirst plans to provide written notification or to gain approval by state insurance regulators, a level of regulation greater than that faced by other health insurance companies in the region. As part of a change in corporate form, CareFirst might be able to work with regulators to be subject to the same regulations as its competition.

This approach to gaining scale could provide other benefits in addition to helping CareFirst better manage costs and access investment capital. Examples include:

- Diversifying CareFirst's business: combining with another health plan could provide CareFirst with a more diverse business (i.e., covering a more diverse set of geographies, with more diverse customer segments and employers), thus helping CareFirst maintain financial stability. During its acquisition of BCBS Maine, Anthem Blue Cross Blue Shield described how this strategy benefited both the plan and its customer base.

"Our focus on growth and financial strength is integral to our strategic plan to remain competitive. With size comes the ability to maximize efficiencies and to withstand regional economic swings. For example, Anthem's size and flexibility allowed our Kentucky subsidiary to stay in the individual market during that state's 1995-1998 experimentation with healthcare reform, a period during which all other commercial carriers exited the market while Anthem persevered and worked with governmental, consumer and industry representatives to produce necessary changes."

- Enhancing CareFirst's attractiveness to larger employers: Expanded scale could increase CareFirst's geographic coverage, making it more attractive to regional and national employers looking to use health plans that cover similar territories. Although Blue Cross Blue Shield plans currently cover the nation, each Blue's operation is distinct, limiting its ability to provide seamless coverage to larger employers compared to nationally consolidated plans).

Since CareFirst lacks sufficient capital to be an acquirer on the scale that it targets, the option described above would likely be structured as a simultaneous for-profit conversion and acquisition of CareFirst by another health plan.

Market forces appear to be driving Blue Cross and Blue Shield plans to pursue mergers and access to the public equity markets. As more and more health plans do so, plans that lack these advantages could find competing more difficult over time. Because such a move could make CareFirst a stronger company, and because CareFirst currently possesses a strong market position, the timing appears favorable for CareFirst to make such a change.

Industry analysts see the conversion of Blue Cross Blue Shield plans as not only wise, but necessary in some cases. Samuel Levitt, a leading analyst and author of a recent report by Conning & Company, says "...the economic realities of healthcare leave them no choice [but to convert to for-profit and access the public equity markets]...we think it's not in general a very friendly environment for non-for-profits." A. M. Best, which analyzes the health insurance industry and rates specific organizations, published an article last year that stated:

"The consolidation of Blue Cross & Blue Shield plans surged during the 1990s and will continue to sweep the insurance industry well into the next

century. Whether it be in response to the regulatory environment, a need for improved efficiencies or simply company survival, mergers and acquisitions have become a primary issue for most insurance companies." Later, the article states, "As consolidations continue and the need for access to capital increases, the conversions to for-profit status will rise symmetrically."

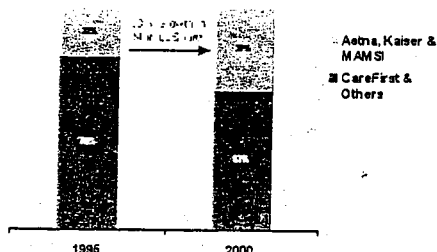
Investment bank Shattuck Hammond states in its Spring 2001 State of the HMO Industry report:

"In order to sustain earnings growth, national HMOs will return to the acquisition market. In addition, we believe that they will become more aggressive in their acquisition valuations" And later: "Rapid Blue Cross Blue Shield consolidation expected to continue...low profitability and limited access to capital have been the two primary factors driving the consolidation. The strong share price performance by the publicly traded Blue Cross Plans as well as additional Blue Cross Blue Shield IPOs and for-profit conversions should further facilitate the consolidation through increased access to capital and diminished geopolitical obstacles."

The timing appears favorable for CareFirst to make such a change because it is profitable and has built a strong market position. As a result, CareFirst could command an attractive price from a prospective buyer. In the past four years, the combined market share of CareFirst's three largest competitors in the region increased from 22% to 37%. Should CareFirst's competitors continue their recent improvements, CareFirst's currently strong negotiating position (by virtue of its strong market position) could be threatened.

Market Share of Competitors

CareFirst's Top Three Competitors Market Share Change, 1995-2000
(Market share in CareFirst's market area)



Source: CareFirst Data, Accenture Analysis

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Should CareFirst choose to pursue this course of action, CareFirst's constituents could benefit significantly.

Benefits could manifest in three ways:

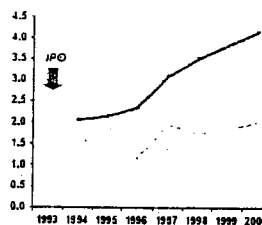
1. Lower premiums due to the potential for greater operating efficiencies,
2. Better service due to enhanced flexibility to invest in new technologies, and
3. Direct funding to meet a variety of health needs by virtue of the formation of substantial Public Benefit Obligation foundations.

To examine the potential impact on constituents, we examined the experiences of two other markets where similar changes occurred. Specifically, we examined the California market where in 1993 Blue Cross of California converted to a for-profit company, issued shares on the New York Stock Exchange, and subsequently acquired health plans in other states. We also examined the Connecticut market where the local non-profit Blue Cross Blue Shield plan was acquired by the larger mutual plan Anthem Blue Cross Blue Shield in 1997. For each market, we examined the financial and competitive performance of the health plans before and after the change. We also interviewed health plan members, employers, brokers, doctors, hospitals, regulators, and foundation leaders in each state and surveyed members of Blue Cross of California.

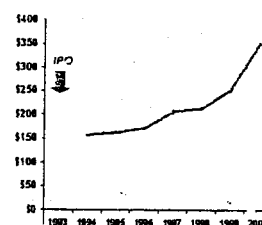
In both case studies, the transformed Blue-branded plans improved their performance and outperformed the competition after their respective transactions. California is a particularly interesting case because it is home to two Blue-branded health plans: Blue Shield of California and Blue Cross of California (WellPoint). Blue Shield remains private and not-for-profit. Blue Cross, as mentioned previously, converted to for-profit and went public. As measured by membership, the plans were close to the same size prior to Blue Cross' change. Since the change, Blue Cross' performance improved significantly relative to Blue Shield's performance.

Blue Cross of CA Compared with Blue Shield of CA

Membership - California
(in Millions)



Net Income - California
(\$ in Millions)



Source: Information, The National Health Financial Statistics, 1990-2000. Data pulled from state Department of Insurance files. Blue Cross membership figures include a 100,000 members acquired through Anthem Health Plan acquisition.

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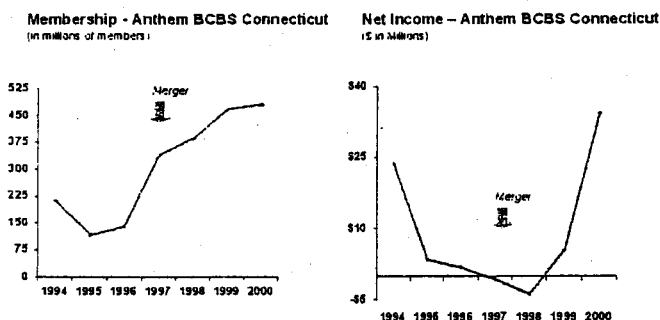
Anthem Blue Cross Blue Shield Connecticut also has experienced strong performance since its merger with Anthem:

- In 1994, there were 13 health plans serving the CT market, with five plans holding greater than 10% market share. BCBS of CT led with a share of 25%. By 2000 only eight plans were still operating, Anthem BCBS CT had grown its market share to 32%, sharing the lead with HealthNet, which also captured 32%.
- Since 1997, Anthem Connecticut's administrative cost ratio (total administrative costs related to

providing health coverage divided by total premium revenues) decreased from 21% to 13%.

- The plan's net income improved from a net loss of \$5 million in 1997 to a net gain of over \$35 million in 2000.

Anthem/BCBS of CT Performance Indicators



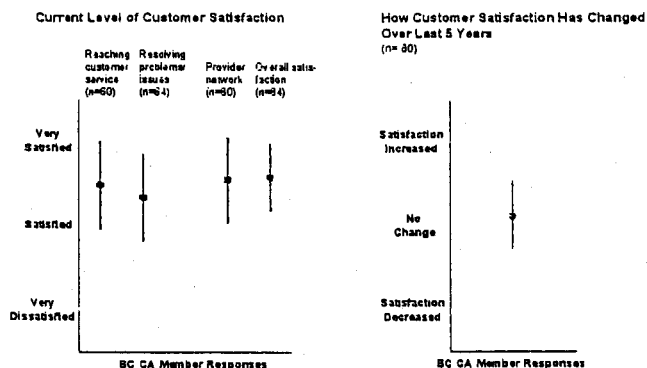
Source: The Interim Group Competitive Edge HMO Industry Report 9.1 & 11.1, April 1999 & April 2001

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Satisfying Constituents

- *Members and employers* who participated in our research reported, on average, that they maintain access to health coverage at competitive premiums and generally appear to perceive their service levels to be at or above the levels they experienced prior to the change. Some members and employers were not aware that a change had taken place. Members and employers in both markets appeared to still very much trust the Blue Cross and Blue Shield brand name.

Blue Cross of California Member Survey Responses



The dot represents the average and the lines represent the range of + and - 1 standard deviation

Source: Accenture survey, 1/00/01

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The health plans believe their premium rate increases to members have become more predictable as a result of their respective transactions. In both cases, the plans reported that the increased emphasis on fiscal discipline caused them to become better at predicting and managing their costs, and as a result, their premiums. One executive at Anthem remarked, "Five years ago, rate changes were all over the place – sometimes high, sometimes low; now that we have admin[istrative] costs more under control and a more disciplined approach, we can manage our rates against healthcare cost trends more effectively." A health insurance broker in Connecticut stated that, "Yes, the prices have risen, but Anthem's have been lower, and more predictable."

Premium predictability is very important to employers, especially small employers, whose health care costs comprise a significant portion of their total employee benefit costs. Wide swings in premiums (e.g., very large increases in one year followed by a small increase in the next year) make it very difficult for them to plan and successfully manage their businesses. So, premium increase predictability is an important benefit to them. Standings for preventive care, service and satisfaction for the Blue-branded plans we analyzed remain at or near the top of the list. In addition to the significant charitable work driven by the Public Benefit Obligation foundations (described below), the converted Blue Cross Blue Shield Plans continue to receive recognition and awards for their care of at-risk populations.

- *Hospitals and Doctors*
 - More Disciplined Contracting Process – Both health plans appeared to have improved their ability to translate market demands and their customers' needs into terms for their doctor and hospital contracts. In this regard, they have become more accountable to their customers (members and employers). They also believe this has caused them